

Outlook on California's Aa2 negative on PG&E's Ch. 11 filing

PRESS RELEASE

NEW YORK, April 6, 2001 -- Moody's has changed its outlook on the State of California's Aa2 general obligation bond rating to negative from stable, reflecting our view that the deepening electric power crisis -- compounded by today's bankruptcy filing by Pacific Gas & Electric Company -- has increased the risks to the state's otherwise strong fiscal and economic condition, notwithstanding the benefits of the sizable rate increase recently approved by the California Public Utility Commission (CPUC) and the state's increased focus on strategies to encourage conservation.

Efforts by the state Department of Water Resources (DWR) to secure power purchase contracts for this year and next appear to be meeting with only moderate success. As a result, the state is forced to continue to purchase a sizable portion of its power in the spot market. The spot market price has remained very high and is likely to continue to be so for the remainder of this year, increasing the risk that the state's financial exposure will persist beyond the period previously expected. While the CPUC's recent rate increase was a positive step in addressing this crisis from a funding perspective, the state's sizable dependence on the high-priced spot market to meet future demand still leaves the DWR facing a potential deficit position, underscoring the magnitude of the problem.

The lack of significant progress toward resolving the strained financial condition of the state's two major utilities, and recent court rulings concerning contracts between the utilities and qualifying facilities (QF), have jeopardized the availability of relatively low-cost QF power resources to these utilities. These factors are disrupting the available power supply and adding to the DWR's power purchase requirements, ultimately increasing the cost of this power to the state. The negotiating stance of the utilities on a number of fronts (including the sale of transmission assets, payments to QF power providers, and establishment of the state's base revenue entitlement) has worked to the state's disadvantage thus far. Today's bankruptcy filing by Pacific Gas & Electric Company (senior unsecured rating of Caa2) could further add to the state's power supply and cost problems.

State general fund advances thus far have not seriously affected its strong liquidity position. However, escalating cost projections and the potential for delay in the sale of power purchase revenue bonds add to the risk of greater and more sustained state general fund involvement. In this context, the Governor's recommended \$1.9 billion budget reserve for fiscal 2002 -- already looking

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budget reserve for fiscal 2002 -- already looking somewhat modest in view of the heightened economic and revenue risks faced by the state -- is potentially an inadequate financial cushion.

Moody's believes an additional risk of the current electricity crisis lies in uncertainty about the reliability and cost of power. It is not clear at this time whether the state will meet its targets for conservation as well as new generation capacity to address this summer's peak demand. These factors, combined with diminished hydroelectric production in the Northwest, increase the likelihood of rolling blackouts this summer and beyond. The potential unreliability and unpredictability of power are a more serious threat to economic growth than the rate recovery/increases that ultimately will be needed to resolve the crisis. Various measures showing that energy costs are a relatively small proportion of total costs of doing business in California support this view. Given the magnitude of the state's expenditure to date, the inability to avoid blackouts, and the size of the rate increases that are likely to be needed, the risk of a potentially disruptive ballot initiative has also increased.



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